FILE COPY

Office - Supreme Court, U. S.
FILED
NOV 4 1942
CHARLES ELMORE CROPLEY
CLERK

No. 66

In the Supreme Court of the United States

OCTOBER TERM, 1942

EMIL H. STRASSBURGER, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Constitutional provisions, statute and regulations involved	2
Statement	2
Summary of argument	4
Argument: Introductory; the statutory provisions involved	9
I. A stock dividend payable out of corporate earnings or profits is constitutionally taxable without apportionment. The contrary ruling in *Eisner* v. *Macomber* should be reexamined	14
A. The scope of the taxing power under the Constitution	14
B. Stock dividends based upon corporate earnings or profits are taxable to the stockholders under Article I and the Sixteenth Amendment without apportionment	22
C. *Eisner* v. *Macomber* should be expressly overruled	42
II. The decision below is correct even if *Eisner* v. *Macomber* be permitted to stand	45
Conclusion	47
Appendix	48

CITATIONS

Cases:	
Alger-Sullivan Lumber Co. v. *Commissioner*, 57 F. (2d) 3	37
Atl. & Pac. Tea Co. v. *Grosjean*, 301 U. S. 412	21
Bailey v. *Railroad Co.*, 22 Wall. 604	6, 22
Bothwell v. *Commissioner*, 77 F. (2d) 35	37
Bromley v. *McCaughn*, 280 U. S. 124	18
Brushaber v. *Union Pac. R. R.*, 240 U. S. 1	4, 15, 20
Burnet v. *Wells*, 289 U. S. 670	36
Chicago, M. & St. P. Ry. Co. v. *Minn. Civic Assn.*, 247 U. S. 490	29
Collector v. *Hubbard*, 12 Wall. 1	6, 28, 29
Commissioner v. *American Chicle Co.*, 65 F. (2d) 454	37
Cooper v. *United States*, 280 U. S. 409	40
Cullinan v. *Walker*, 262 U. S. 134	32, 33, 34
Doerschuck v. *United States*, 274 Fed. 739	31
Douglas v. *Willcuts*, 296 U. S. 1	14, 36
Dreyfuss v. *Manning*, 44 F. Supp. 383, appeal pending	45

Cases—Continued. Page

Duffin v. *Lucas*, 55 F. (2d) 786, certiorari denied, 287 U. S. 611 36
Eisner v. *Macomber*, 252 U. S. 189 ..... 6, 7, 9, 10, 13, 24, 25, 28, 31, 32, 34, 38, 39, 42, 44
Flint v. *Stone Tracy Co.*, 220 U. S. 107 ..... 18, 20
Gibbons v. *Mahon*, 136 U. S. 549 24
Graves v. *N. Y. ex rel. O'Keefe*, 306 U. S. 466 20
Griffiths v. *Commissioner*, 308 U. S. 355 29
Gulf Oil Corp. v. *Lewellyn*, 248 U. S. 71 29
Haberman v. *Commissioner*, 31 B. T. A. 75, affirmed, *per curiam*, 79 F. (2d) 995 37
Hale v. *State Board*, 302 U. S. 95 20
Hawke v. *Commissioner*, 109 F. (2d) 946 37
Heiner v. *Mellon*, 304 U. S. 271 ..... 6, 26
Helvering v. *American Chicle Co.*, 291 U. S. 426 36
Helvering v. *Blumenthal*, 296 U. S. 552 36
Helvering v. *Bruun*, 309 U. S. 461 ..... 8, 37
Helvering v. *Clifford*, 309 U. S. 331 ..... 14, 36
Helvering v. *Commerical Investment Trust Corp.*, 74 F. (2d) 1015, affirming, *per curiam*, 28 B. T. A. 143 37
Helvering v. *Eubank*, 311 U. S. 122 36
Helvering v. *Fitch*, 309 U. S. 149 36
Helvering v. *Gowran*, 302 U. S. 238 ..... 31, 32, 34, 45, 46
Helvering v. *Hallock*, 309 U. S. 106 13
Helvering v. *Horst*, 311 U. S. 112 36
Helvering v. *Leonard*, 310 U. S. 80 36
Helvering v. *Midland Ins. Co.*, 300 U. S. 216 ..... 14, 46
Helvering v. *Nat. Grocery Co.*, 304 U. S. 282 29
Helvering v. *Pfeiffer*, 302 U. S. 247 45
Helvering v. *Schweitzer*, 296 U. S. 551 36
Helvering v. *Stockholms &c. Bank*, 293 U. S. 84 14
Higgins v. *Smith*, 308 U. S. 473 29
Hylton v. *United States*, 3 Dall. 171 ..... 14, 16, 17
Indianapolis Glove Co. v. *United States*, 96 F. (2d) 816 37
Knowlton v. *Moore*, 178 U. S. 41 ..... 18, 20
Koshland v. *Helvering*, 298 U. S. 441 ..... 7, 11, 31, 32, 34, 42, 45, 46
Lanning v. *Tax Commissioner*, 247 Mass. 496 23
Lucas v. *Earl*, 281 U. S. 111 36
Lynch v. *Hornby*, 247 U. S. 339 ..... 29, 40
Lynch v. *Turrish*, 247 U. S. 221 29
Marr v. *United States*, 268 U. S. 536 ..... 32, 33, 34
Martin v. *Hunter's Lessee*, 1 Wheat. 304 23
Marshall v. *Baltimore and Ohio Railroad Co.*, 16 How. 314 25
Maxwell v. *Bugbee*, 250 U. S. 525 21
McCreery v. *McColgan*, 17 Cal. (2d) 555 29
McCulloch v. *Maryland*, 4 Wheat. 316 23
New York Trust Co. v. *Eisner*, 256 U. S. 345 18

Cases—Continued.

	Page
Nicol v. *Ames*, 173 U. S. 509	18
Northern Securities Co. v. *United States*, 193 U. S. 197	29
N. Y. ex rel. Cohn v. *Graves*, 300 U. S. 308	19
Old Colony Tr. Co. v. *Commissioner*, 279 U. S. 716	36
O'Malley v. *Woodrough*, 307 U. S. 277	20
Pacific Insurance Co. v. *Soule*, 7 Wall. 433	17, 18
Peck & Co. v. *Lowe*, 247 U. S. 165	22
Peabody v. *Eisner*, 247 U. S. 347	40
People ex rel. Pullman Co. v. *Glynn*, 130 App. Div. 332, affirmed, 198 N. Y. 605	23
Pollock v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601	5, 19, 22, 29
Railroad Co. v. *Collector*, 100 U. S. 595	18
Robinson v. *Commissioner*, 59 F. (2d) 1008	37
Rockefeller v. *United States*, 257 U. S. 176	32, 33, 34
Salvage v. *Commissioner*, 76 F. (2d) 112, affirmed, 297 U. S. 106	37
Scholey v. *Rew*, 23 Wall. 331	18
Southern Pacific Co. v. *Lowe*, 247 U. S. 330	29
Springer v. *United States*, 102 U. S. 586	5, 14, 17
Standard Oil Co. v. *United States*, 221 U. S. 1	29
Stanton v. *Baltic Mining Co.*, 240 U. S. 103	22
State ex rel. Dulaney v. *Nygaard*, 174 Wis. 597	24
Steward Machine Co. v. *Davis*, 301 U. S. 548	18
Taft v. *Bowers*, 278 U. S. 470	40
Tax Commissioner v. *Putnam*, 227 Mass. 522	23
Thomas v. *United States*, 192 U. S. 363	21
Trent v. *White*, 181 U. S. 264	18
United States v. *Fuller*, 42 F. (2d) 471	31
United States v. *Hendler*, 303 U. S. 564	36
United States v. *Kirby Lumber Co.*, 284 U. S. 1	36
United States v. *Lehigh Valley R. R. Co.*, 220 U. S. 257	29
United States v. *Phellis*, 257 U. S. 156	32, 34, 40
United States v. *Reading Co.*, 253 U. S. 26	29
United States v. *Safety Car Heating Co.*, 297 U. S. 88	14
United States v. *U. S. Steel Corp.*, 251 U. S. 417	29
United States v. *Wrightwood Dairy Co.*, 315 U. S. 110	13
Veazie Bank v. *Fenno*, 8 Wall. 533	18, 21
Weiss v. *Stearn*, 265 U. S. 242	32
Wisconsin v. *J. C. Penney Co.*, 311 U. S. 435	21
Constitution and Statutes:	
Constitution of the United States:	
Art. 1, Sec. 2, Clause 3	15, 48
Art. 1, Sec. 8, Clause 1	4, 15, 48
Art. 1, Sec. 9, Clause 4	15, 48
Clause 5	15, 48
Sixteenth Amendment	48

Constitution and Statutes—Continued. Page

1 Stat. 53 ... 18
1 Stat. 373 ... 16
3 Stat. 53, 164, 255 ... 18
12 Stat. 294 ... 18
Revenue Act of 1918, c. 18, 40 Stat. 1057, Sec. 240 ... 29
Revenue Act of 1921, c. 136, 42 Stat. 227:
Sec. 201 ... 10
216 ... 29
240 ... 29
Revenue Act of 1924, c. 234, 43 Stat. 253:
Sec. 201 ... 10
216 ... 29
240 ... 29
Revenue Act of 1926, c. 27, 44 Stat. 9:
Sec. 201 ... 10
216 ... 29
240 ... 29
Revenue Act of 1928, c. 852, 45 Stat. 791:
Sec. 25 ... 29
115 ... 10
141 ... 29
Revenue Act of 1932, c. 209, 47 Stat. 169:
Sec. 25 ... 29
115 ... 10
141 ... 29
Revenue Act of 1934, c. 277, 48 Stat. 680:
Sec. 25 ... 29
115 ... 10
141 ... 29
Revenue Act of 1936, c. 690, 49 Stat. 1648:
Sec. 22 ... 10, 49
115 ... 10, 11, 49
141 ... 29
Revenue Act of 1938, c. 289, 52 Stat. 447, Sec. 141 ... 29
Internal Revenue Code, Sec. 26 (b) ... 29

Miscellaneous:
Ballantine, Corporate Personality in Income Taxation, 34 Harv. L. Rev. 573, 581 (1921) ... 44
Clark, *Eisner* v. *Macomber* and Some Income Tax Problems, 29 Yale L. J. 735, 742 (1920) ... 44
80 Cong. Rec., part 6, pp. 6214–15, 6309–10 ... 13
Documents, Formation of the United States (Government Printing Office, 1927), p. 580 ... 16
Federalist, The, No. 21 ... 15
Federalist, The, No. 30 ... 15, 17
Fletcher, Cyclopedia Corporations, Vol. 6 (1931), Sec. 2615 ... 41

Miscellaneous—Continued.

	Page
Fletcher, Cyclopedia Corporations, Vol. 11 (1932), Secs. 5149, 5150	41
Fletcher, Cyclopedia Corporations, Vol. 13 (1932), Sec. 6277	41
1 Hare, American Constitutional Law (1889), p. 250	18
H. R. 12395, 74th Cong., 2d Sess., sec. 115 (f) (1)	12
H. Rep. No. 350, 67th Cong., 1st Sess. (1939–1 Cum. Bull. (Part 2) 168)	10, 43
H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 2–3 (1939–1 Cum. Bull. (Part 2) 728, 729)	43
H. Rep. No. 2475, 74th Cong., 2d Sess., p. 10	13
Hohfeld, Nature of Stockholders' Individual Liability for Corporation Debts, 9 Col. L. Rev. 285 (1909)	25
1 Hurd, Law of Freedom and Bondage, p. 239	18
1 Kent, Commentaries *256	18
Martin, Taxation of Undistributed Corporate Profits, 35 Mich. L. Rev. 44, 45 (1936)	44
Miller, Constitution (1891), p. 237	18
Morawetz, Private Corporations (Second Edition, 1886), Volume 1, preface	25
Pomeroy, Constitutional Law (3d ed., 1888), § 277	18
Powell, The Stock Dividend Decision and the Corporate Nonentity, 5 Nat. Tax Assn. Bull. 201 (1920)	44
Rawle, Constitution (2d ed., 1829), p. 80	18
Seligman, Implications and Effects of the Stock Dividend Decision, 21 Col. L. Rev. 313, 323 (1921)	44
Sergeant, Constitutional Law (1830), p. 305	18
S. Rep. No. 275, 67th Cong., 1st Sess. (1939–1 Cum. Bull. (Part 2) 181)	11, 43
S. Rep. No. 2156, 74th Cong., 2d Sess., pp. 18–19	12, 13
S. Rep. No. 2156, 74th Cong., 2d Sess., part 2, p. 2	43
1 Story, Constitution of United States (4th ed., 1873), § 955	18
Traynor, Tax Decisions of the Supreme Court, 1937 Term, 33 Ill. L. Rev. 371 (1938)	44
T. D. 3206, 5 Cum. Bull. 42, amending Art. 1547, Treasury Regulations 45 (1920 ed.)	11
T. D. 5020, 1940–2 Cum. Bull. 118	13, 53
T. D. 5110, 1942–4 Int. Rev. Bull. 7	13, 53
Treasury Regulations 62, Art. 1548	11
Treasury Regulations 65, Art. 1548	11
Treasury Regulations 69, Art. 1548	11
Treasury Regulations 74, Art. 628	11
Treasury Regulations 77, Art. 628	11
Treasury Regulations 86, Art. 115–8	11
Treasury Regulations 94, Art. 115–7	13, 50
Treasury Regulations 101, Art. 115–7	13
Treasury Regulations 103, Sec. 19.115–7	13

In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 66

EMIL H. STRASSBURGER, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The memorandum opinion of the Board of Tax Appeals (R. 12–17) is not officially reported. The opinions of the Circuit Court of Appeals (R. 32–35) are reported in 124 F. (2d) 315.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on January 7, 1942 (R. 36). The petition for a writ of certiorari was filed on April 3, 1942, and was granted on May 11, 1942. The jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the owner of all the issued voting common stock of a corporation realized taxable income upon the receipt of a stock dividend paid in seven percent nonvoting cumulative preferred stock, which was declared out of the corporation's earnings and profits.

CONSTITUTIONAL PROVISIONS, STATUTE AND REGULATIONS INVOLVED

The constitutional provisions, statute and regulations involved are set forth in the Appendix, *infra*, pp. 48–53.

STATEMENT

The facts, as stipulated (R. 25–27) and as found by the Board of Tax Appeals (R. 12–14), may be summarized as follows:

E. H. Strassburger, Inc., hereinafter referred to as the corporation, was organized in or about January of 1932. On December 10, 1936, its authorized capital stock consisted of 200 shares of common stock with exclusive voting rights. The petitioner owned all this stock. (R. 12–13.)

On December 11, 1936, the corporation's articles of incorporation were amended to provide for the issuance of 500 shares of $100 par value seven percent cumulative nonvoting preferred stock (R. 13). On December 21, 1936, the corporation's board of directors adopted a resolution of which the following is material (R. 13):

> NOW, THEREFORE, BE IT RESOLVED, that for the purpose of representing in the capitali-

zation of this corporation surplus assets to the extent of Five Thousand Dollars, a distribution among stockholders of the capital stock of the corporation be made of Five Thousand Dollars of preferred capital stock, and the proper officers of the corporation are hereby authorized and directed to issue an aggregate of Five Thousand Dollars, par value of preferred capital stock of this corporation, in payment of a stock dividend on the common stock of this corporation.

FURTHER RESOLVED, that the directors of this corporation be authorized to distribute said Five Thousand Dollars of the preferred capital stock, pro rata, among stockholders, as and for a stock dividend on said capital stock so owned by them, such distribution to be made to stockholders of record at the close of business on December 24, 1936.

On December 24, 1936, 50 shares of the preferred stock were issued to the taxpayer, the sole common stockholder, in pursuance of the resolution. At the time of the distribution of this stock dividend, the corporation had earnings and profits accumulated subsequent to February 28, 1913, in excess of $5,000. Appropriate book entries were made on account of the dividend decreasing the surplus of the corporation by $5,000 and increasing its capital stock in the same amount. (R. 13–14.)

On December 29, 1936, the 50 shares of preferred stock, which the taxpayer had thus re-

ceived as a dividend, were transferred to his wife, Gertrude W. Strassburger. Upon her death the shares were retransferred to the taxpayer, who is now the record holder. No dividends have been paid on the preferred stock, and that stock has never been disposed of, canceled, or retired. (R. 14.)

The Board of Tax Appeals held that the stock dividend constituted taxable income (R. 14–17). The court below affirmed, Judge Chase dissenting (R. 32–35).

SUMMARY OF ARGUMENT

In Sections 22 (a) and 115 of the Revenue Act of 1936 Congress has exercised its power to tax stock dividends as income to the full extent permitted by the Constitution. The only question, therefore, is as to the extent of its authority under the Constitution.

I

A. The basic power to tax rests upon Article I, Section 8, Clause 1, of the Constitution. That power "is exhaustive and embraces every conceivable power of taxation." *Brushaber* v. *Union Pac. R. R.*, 240 U. S. 1, 12. Apart from the specific prohibition against taxing exports, the taxing power is subject only to two restrictions: (1) duties, imposts, and excises must be uniform throughout the United States; and (2) "direct" taxes must be apportioned among the states according to population.

Thus, stock dividends are obviously subject to tax under the sweeping authority of Article I, Section 8, Clause 1, the only question being whether the tax is "direct" and is therefore subject to the apportionment requirement.

The practice of Congress and the decisions of this Court during the first century under the Constitution show that the unworkable apportionment requirement was intended to have but very limited application. Indeed, this Court had held that only capitation taxes and taxes upon real estate were embraced within the term "direct taxes." *Springer* v. *United States,* 102 U. S. 586, 602. However, a sharply divided Court in *Pollock* v. *Farmers' Loan & Trust Co.,* 157 U. S. 429, 158 U. S. 601, thereafter held that the 1894 income-tax statute was unconstitutional in part, at least, because the tax upon income from real estate was not apportioned. The Sixteenth Amendment was then adopted and in effect constituted a reversal of that decision.

It seems abundantly clear that but for the *Pollock* decision, stock dividends based upon corporate earnings are constitutionally taxable without apportionment under Article I, and that whatever doubt the *Pollock* case had cast upon the validity of such a tax has been removed by the Sixteenth Amendment.

B. 1. In providing that a tax upon "income" need not be apportioned, the Sixteenth Amendment employed that term in its broadest sense

and was designed to put at rest all such questions as are here presented. Even before the *Pollock* case, stock dividends were regarded *as income* under the Civil War income tax laws (*Bailey* v. *Railroad Co.*, 22 Wall. 604, 635), and the reversal of the *Pollock* decision through the Sixteenth Amendment was certainly not intended to leave Congress with less power than it was thought to possess before that decision. The contrary ruling in *Eisner* v. *Macomber*, 252 U. S. 189, is erroneous and should be re-examined.

2. There is an even more fundamental reason which justifies the tax upon a stock dividend to the extent that it is supported by corporate earnings. Congress has the authority to treat a corporation as an association of individuals who have united for the purpose of conducting a business enterprise, and it may require each of them to account periodically with respect to his pro rata share of the corporate profits. This Court has already sustained such a tax against members of a partnership with respect to their distributive share of the partnership earnings notwithstanding that those earnings in fact could not have been distributed during the year in question. *Heiner* v. *Mellon*, 304 U. S. 271, 280–281. And under the Civil War income tax laws, corporate earnings were actually taxed directly to the stockholders, whether distributed or not. *Collector* v. *Hubbard*, 12 Wall. 1, 18. If the stockholder's pro rata share of the cor-

porate earnings were treated as income to him under those early income tax laws, surely the sweeping terms of the Sixteenth Amendment should be given no narrower interpretation. Accordingly, if Congress may tax the stockholders upon their share of the corporate earnings, it plainly has the lesser power of taxing such earnings to the stockholders when stock dividends have been declared against them. Of course, the mere declaration of a stock dividend is not an income-producing transaction; but it does mark the occasion when the shareholder may be asked to account for the profit that has been accruing up to that point of time, and the stock dividend embodying that profit may be treated as "income."

3. The decision in *Eisner* v. *Macomber* not only misconceived the broad scope of the taxing power under Article I and failed to recognize the known purpose of the Sixteenth Amendment, but, in addition, introduced certain erroneous concepts and refinements as to the "realization" of "income" which have been repudiated by other decisions of this Court.

Thus, it held that a stock dividend could not constitute income because there was no "outgo" from the corporation. However, *Koshland* v. *Helvering*, 298 U. S. 441, and other decisions of this Court, are squarely to the contrary.

Again, it was held in *Eisner* v. *Macomber* that profit must be "severed" from capital before it

can be treated as "income." Numerous subsequent decisions are plainly inconsistent with that ruling. See particularly, *Helvering* v. *Bruun*, 309 U. S. 461.

Finally, the entire decision appeared to be pervaded by the fundamental misconception that there could be no income to the stockholder because he was no wealthier immediately after the stock dividend than he had been immediately before. But the same is true whenever a capital asset is sold or exchanged at a profit. Generally, the taxpayer is no wealthier immediately after such a sale or exchange than he had been the moment before: the sale or exchange simply marks the moment of time when the profit which has theretofore been accruing gradually may be charged to him. Similarly, the declaration of the stock dividend simply constitutes the occasion when corporate earnings, which have been accumulating over a period of time, may be charged to those who are the beneficial owners of those earnings. Fundamentally, the problem of "realization" is merely one of finding an appropriate time for the measurement of a taxpayer's increase in wealth in order to compute, in accordance with the principle of ability to pay, the amount of his contribution toward the maintenance of the society in which he lives. That problem is essentially, and by its very nature, legislative in character and we urge that the Sixteenth Amendment left the reso-

lution of such questions in the legislative branch of the Government. Congress should be left free to designate any convenient event as appropriate for the measurement of increases in wealth. The concept of "realization" should impose no greater restraint than this.

C. If, as we contend, *Eisner* v. *Macomber* was erroneously decided, it should be expressly overruled. The decision has not only been the source of great confusion, but it has long cast a restrictive influence upon the Treasury and Congress in developing a sound system for the taxation of corporate earnings in the hands of those who are the beneficial owners of those profits. The public interest requires that fiscal policies be allowed to develop free from the shadow of erroneous constitutional limitations.

II

Although we think that *Eisner* v. *Macomber* should be expressly overruled, the decision below may be affirmed upon the narrow ground that the dividend stock received was preferred stock and embodied new rights that were different from the common stock upon which it had been declared.

ARGUMENT

Introductory; the statutory provisions involved.—Since the preferred stock dividend was paid out of the corporation's earnings and profits accumulated after February 28, 1913, it was specif-

ically covered by Sections 22 and 115 of the Revenue Act of 1936, c. 690, 49 Stat. 1648 (Appendix, *infra*, p. 49). Section 22 (a) defines gross income as including "gains, profits, and income derived from * * * dividends * * *," and Section 22 (d) declares that corporate distributions "shall be taxable to the shareholders as provided in section 115." Section 115 (a) defines a dividend to include "any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, * * *." And Section 115 (f) (1) thereupon in effect provides that a stock dividend shall be treated as a dividend to the extent that it constitutes income to the shareholder within the meaning of the Sixteenth Amendment. The history of these provisions is illuminating.

As a result of the broad language of the majority opinion in *Eisner* v. *Macomber*, 252 U. S. 189, it was erroneously assumed both by Congress[1] and

[1] After that decision, Congress provided in sweeping language in all of the revenue acts from 1921 through 1934 that "a stock dividend shall not be subject to tax." Revenue Act of 1921, c. 136, 42 Stat. 227, Section 201 (d); Revenue Act of 1924, c. 234, 43 Stat. 253, Section 201 (f); Revenue Act of 1926, c. 27, 44 Stat. 9, Section 201 (f); Revenue Act of 1928, c. 852, 45 Stat. 791, Section 115 (f); Revenue Act of 1932, c. 209, 47 Stat. 169, Section 115 (f); Revenue Act of 1934, c. 277, 48 Stat. 680, Section 115 (f). These provisions were stated in the committee reports to have been "required by the decision of the Supreme Court in *Eisner* v. *Macomber*." See H. Rep. No. 350, 67th Cong., 1st Sess., p. 8 (1939–1 Cum. Bull.

by the Treasury[2] that all kinds of stock dividends fell within the condemnation of that decision, and accordingly all stock dividends were thereafter specifically exempted by statute. It was subsequently shown, however, in *Koshland* v. *Helvering*, 298 U. S. 441, 444–447, that such an assumption was unwarranted, since there were at least some types of stock dividends that were not governed by *Eisner* v. *Macomber*. And in order to avoid such confusion in the future, the Revenue Act of 1936, enacted shortly after the *Koshland* decision, provided that taxability should be coextensive with constitutional power. Thus, Section 115 (f) (1) of the 1936 Act declares:

> (f) STOCK DIVIDENDS.—
>
> (1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(Part 2) 168, 175); S. Rep. No. 275, 67th Cong., 1st Sess., p. 9 (1939–1 Cum. Bull. (Part 2) 181, 187).

[2] See T. D. 3206, 5 Cum. Bull. 42, amending Article 1547 of Treasury Regulations 45 (1920 edition); Article 1548, Treasury Regulations 62 (promulgated under the Revenue Act of 1921), 65 (promulgated under the Revenue Act of 1924), and 69 (promulgated under the Revenue Act of 1926); Article 628, Treasury Regulations 74 (promulgated under the Revenue Act of 1928) and 77 (promulgated under the Revenue Act of 1932); Article 115–8 of Treasury Regulations 86 (promulgated under the Revenue Act of 1934).

486794—42——3

Although the rule is stated negatively in this provision, the legislative history makes its meaning clear beyond question. As originally reported to and passed by the House, Section 115 (f) (1) of the 1936 revenue bill read as follows (H. R. 12395, 74th Cong., 2d Sess.):

> (f) STOCK DIVIDENDS.—
>
> (1) *General Rule.*—A distribution made by a corporation to its shareholders in stock of the corporation or in rights to acquire stock of the corporation shall be treated as a taxable dividend to the extent that such distribution constitutes income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution and represents a distribution of earnings or profits accumulated after February 28, 1913.

However, as a result of certain changes in Section 115 (a) which were made in the Senate, it was thought necessary to reword Section 115 (f) (1) so that it would conform to the changes in 115 (a). Accordingly, Section 115 (f) was rephrased, but the report of the Senate Finance Committee made it plain that there was no intention to change its meaning or effect (S. Rep. No. 2156, 74th Cong., 2d Sess., pp. 18–19):

> SECTION 115 (F). STOCK DIVIDENDS.
>
> This subsection of the House bill, under which stock dividends are made taxable to the full extent permitted by the Constitution, is retained by your committee, except for changes made necessary by virtue of the

reported amendment of section 115 (a) and in the interest of greater clarity.

Moreover, the Treasury Regulations issued under the 1936 and subsequent revenue acts all construe Section 115 (f) (1) as follows:[3]

> A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the mean-

---

[3] See Article 115–7 of Treasury Regulations 94 (Appendix, *infra*) and 101 (promulgated under the Revenue Act of 1938), and Section 19.115–7 of Treasury Regulations 103 (promulgated under the Internal Revenue Code).

As originally promulgated, the regulations went further, and undertook to discuss the decisions of this Court in an attempt to indicate how far the tax could be imposed under the Constitution. However, that discussion was subsequently eliminated by T. D. 5020 and T. D. 5110 (Appendix, *infra*, p. 53), thus leaving only the sentence quoted above. Since that discussion was merely an attempt to state the result of the decisions of this Court rather than to interpret the statute, it, of course, could have no binding effect. Cf. *Helvering* v. *Hallock*, 309 U. S. 106, 121, footnote 8. Similarly, the statements made in Congress (80 Cong. Rec., part 6, pp. 6214–15, 6309–10) that the new provisions were not an "attack upon" *Eisner* v. *Macomber*, simply indicate that Congress was legislating to the full extent of its power, and that it was leaving to the courts the question of how far its power extended. Any doubt on this question is removed by the reports of both the House and Senate committees which unambiguously stated that stock dividends were to be taxed "to the full extent permitted by the Constitution." See S. Rep. No. 2156, 74th Cong., 2d Sess., p. 18; H. Rep. No. 2475, 74th Cong., 2d Sess., p. 10. A similar situation was present in *United States* v. *Wrightwood Dairy Co.*, 315 U. S.

ing of the sixteenth amendment to the Constitution. * * *

Therefore, if Congress has the power under the Constitution to tax the stock dividend in question, it has exercised that power here. Cf. *Helvering* v. *Stockholms &c. Bank*, 293 U. S. 84, 89; *Douglas* v. *Willcuts*, 296 U. S. 1, 9; *United States* v. *Safety Car Heating Co.*, 297 U. S. 88, 93; *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, 223; *Helvering* v. *Clifford*, 309 U. S. 331, 334.

I

A STOCK DIVIDEND PAYABLE OUT OF CORPORATE EARNINGS OR PROFITS IS CONSTITUTIONALLY TAXABLE WITHOUT APPORTIONMENT. THE CONTRARY RULING IN *EISNER* V. *MACOMBER* SHOULD BE REEXAMINED

A. *The scope of the taxing power under the Constitution*

The lack of any effective power to tax was regarded as one of the principal weaknesses of the national government under the Articles of Confederation, and indeed "was one of the causes that led to the adoption of the present Constitution." *Springer* v. *United States*, 102 U. S. 586, 595–596. Cf. *Hylton* v. *United States*, 3 Dall. 171, 178; The

110, 121–125, where the Court held that Congress had evidenced an intention to exercise its power to the full extent permitted by the commerce clause under the Constitution, and where the Court rejected statements of some members of the Senate to the contrary.

Federalist, Nos. 21, 30.[4] In response to the then existing critical situation the Constitution conferred upon Congress an all-embracing power to tax in Article I, Section 8, Clause 1, which provides:

> The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States; * * *

The authority so conferred "is exhaustive and embraces every conceivable power of taxation." *Brushaber* v. *Union Pac. R. R.*, 240 U. S. 1, 12. Apart from the specific prohibition against levying a tax or duty upon exports (Art. I, Sec. 9, cl. 5), the foregoing basic power to tax is plenary, and the mode of its exercise is limited only by two restrictions: (1) duties, imposts, and excises must be uniform throughout the United States (Art. I, Sec. 8, cl. 1); and (2) direct taxes must be apportioned among the states according to population (Art. I, Sec. 2, cl. 3, and Art. I, Sec. 9, cl. 4)

Thus, it is plain, and indeed it has never been disputed, that Congress may tax stock dividends under the sweeping authority of Article I, Section

[4] In the Federalist, No. 30, attributed to Alexander Hamilton, it was stated that the weakness of the system of obtaining revenue through requisitions under the Articles of Confederation "has chiefly contributed to reduce us to a situation, which affords ample cause both of mortification to ourselves, and of triumph to our enemies."

8, clause 1. The only objection to the tax is that it is a "direct" tax, that it must therefore be apportioned among the states according to population, and that the Sixteenth Amendment has failed to relieve the tax of the apportionment requirement.

The apportionment requirement was intended to have only a very limited application; for, although the Constitution contains no definition[5] of "direct taxes," it soon became clear that only capitation taxes and taxes on real estate were regarded as direct taxes. As early as 1794 Congress imposed a tax upon carriages (1 Stat. 373) which was challenged because it was not apportioned, but its validity was sustained by this Court in *Hylton* v. *United States*, 3 Dall. 171. Of the four justices who participated, two (Wilson and Paterson) had been members of the Constitutional convention, and Alexander Hamilton, then in private life, appeared together with the Attorney General in support of the tax. Although the Court found it unnecessary to define a direct tax, it was indicated that the Constitution contemplated only two direct taxes, a capitation or poll tax and a tax upon land. See 3 Dall. at 175.[6]

---

[5] Nor are the debates in the Constitutional convention illuminating upon this question. Madison's journal indicates that although Rufus King asked what was "the precise meaning of *direct* taxation", no one answered. See Documents, Formation of the United States (Govt. Printing Office 1927), p. 580.

[6] The concept of apportioned taxes was undoubtedly derived from the crude practice which existed under the Ar-

For nearly a century after the *Hylton* case Congress imposed and this Court sustained a wide variety of unapportioned taxes. That period was rich in history that served to confirm the full scope of the taxing power. Of particular note was *Springer* v. *United States*, 102 U. S. 586, 602, in which the Court expressly ruled that capitation and real estate taxes were the only taxes covered by the constitutional requirement of apportionment, and in which the Court upheld the income taxes im-

---

ticles of Confederation. Under the Confederacy, the Congress would from time to time estimate the needs of the national government and would make requisitions upon the individual states according to some method of apportionment. See The Federalist, No. 30. But it was plain that an apportioned tax could have only a very limited sphere of operation under the Constitution. For example, as observed by Mr. Justice Chase in the *Hylton* case, if the carriage tax were apportioned, there might be two states equal in population, one of which might have ten times as many carriages as the other. The consequence would be that the owner of a carriage in one of those states would be subject to a burden ten times as great as a similar owner in the other state. See 3 Dall. at 174. And in *Pacific Insurance Co.* v. *Soule*, 7 Wall. 433, 446, involving a tax upon receipts of insurance companies, it was pointed out that if the tax were apportioned, it would be light where such corporations were numerous and rich, and that in those states where they were few and poor the tax "would fall upon them with such weight as to involve annihilation." The Court added "It cannot be supposed that the framers of the Constitution intended that any tax should be apportioned, the collection of which on that principle would be attended with such results. The consequences are fatal to the proposition." *Ibid.*

posed during the Civil War.[7] Moreover, the practice of Congress, particularly during the early years, under the Constitution, confirms this view. For, the only apportioned taxes that it attempted to levy were upon real estate.[8] And such commentators as Story, Kent, and Miller, who enjoy a particularly high place in American jurisprudence, were unanimous in indicating that direct taxes were to be limited to capitation and real estate taxes.[9] Surely, here was a situation in which "a page of history is worth a volume of logic" (*New York Trust Co.* v. *Eisner*, 256 U. S. 345, 349).

---

[7] Similarly, the Court had sustained a tax upon receipts of insurance companies in *Pacific Insurance Co.* v. *Soule*, 7 Wall. 433. The well-known bank note tax likewise survived the contention that it was invalid as an unapportioned direct tax. *Veazie Bank* v. *Fenno*, 8 Wall. 533. In *Scholey* v. *Rew*, 23 Wall. 331, the Court sustained an unapportioned tax upon successions. See also *Railroad Co.* v. *Collector*, 100 U. S. 595; *Knowlton* v. *Moore*, 178 U. S. 41; *New York Trust Co.* v. *Eisner*, 256 U. S. 345; *Bromley* v. *McCaughn*, 280 U. S. 124; *Nicol* v. *Ames*, 173 U. S. 509; *Treat* v. *White*, 181 U. S. 264; *Flint* v. *Stone Tracy Co.*, 220 U. S. 107; *Steward Machine Co.* v. *Davis*, 301 U. S. 548, 578-583.

[8] See 1 Stat. 53; 3 Stat. 53; 3 Stat. 164; 3 Stat. 255; 12 Stat. 294. Several of these statutes also included an apportioned tax upon slaves, but at that time slaves were regarded in some of the states as real estate. See 1 Hurd, Law of Freedom and Bondage, p. 239.

[9] 1 Story, Constitution of United States (4th ed., 1873), § 955; 1 Kent, Commentaries *256; Miller, Constitution (1891), p. 237. Cf. Rawle, Constitution (2d ed., 1829), p. 80; Pomeroy, Constitutional Law (3d ed., 1888), § 277; Sergeant, Constitutional Law (1830), p. 305; 1 Hare, American Constitutional Law (1889), p. 250.

Notwithstanding the historical background outlined above, it was held in *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601, that a tax upon income from property is equivalent to a tax upon the property itself, that it is therefore a direct tax and is invalid unless apportioned. But it is to be observed that even the *Pollock* decision [10] did not hold that an income tax generally was a direct tax, and indeed the majority opinion intimated that a tax on professional

[10] Although this Court undertook to distinguish the *Pollock* case in *N. Y. ex rel. Cohn* v. *Graves*, 300 U. S. 308, it in effect destroyed the basis upon which the *Pollock* case rested. The *Graves* case involved a New York tax upon rents derived from New Jersey real estate. In holding that New York could tax those rents even though it was without power to tax the property, the Court said (p. 314):

> Neither analysis of the two types of taxes, nor consideration of the bases upon which the power to impose, them rests, supports the contention that a tax on income is a tax on the land which produces it. The incidence of a tax on income differs from that of a tax on property. Neither tax is dependent upon the possession by the taxpayer of the subject of the other. His income may be taxed, although he owns no property, and his property may be taxed, although it produces no income. The two taxes are measured by different standards, the one by the amount of income received over a period of time, the other by the value of the property at a particular date. Income is taxed but once; the same property may be taxed recurrently. The tax on each is predicated upon different governmental benefits; the protection offered to the property in one state does not extend

earnings would not have to be apportioned. 157 U. S. at 579. The statute was invalidated as a whole, however, only because it was thought that Congress intended its various provisions to be inseparable from each other. 158 U. S. at 635–637. Accordingly, even after the *Pollock* case there was considerable room for the imposition of unapportioned income taxes under the Constitution as it then stood. Cf. *Flint* v. *Stone Tracy Co.*, 220 U. S. 107. Nevertheless, it was desired to untie the hands of Congress completely, and the Sixteenth Amendment was adopted. Under the Amendment, the power of Congress was not to be restricted by reason of the source of the income. It specifically provided:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The Amendment was not designed as a limitation upon the taxing power. Rather, it was intended to *expand* the taxing authority, giving full scope to Congressional power under Article I, unencumbered by the unworkable requirement of appor-

---

to the receipt and enjoyment of income from it in another.

See also *Knowlton* v. *Moore*, 178 U. S. 41, 82; *Brushaber* v. *Union Pac. R. R.*, 240 U. S. 1, 16; *Hale* v. *State Board*, 302 U. S. 95, 107; *Graves* v. *N. Y. ex rel. O'Keefe*, 306 U. S. 466; *O'Malley* v. *Woodrough*, 307 U. S. 277.

tionment which the majority of the Court thought existed with respect to certain types of income.

No one has ever doubted that stock dividends could be taxed under the plenary power granted by Article I, the only question being whether the tax must be apportioned. We submit that even under the *Pollock* decision, there is no foundation for the conclusion that a tax upon stock dividends is a direct tax,[11] and that in any event whatever basis there may have been for the apportionment requirement has been removed by the Sixteenth Amendment. Even after the Sixteenth Amendment the basic power to tax continues to rest upon Article I; that power is all embracing; and the Sixteenth Amendment was intended to sweep away any possible qualifications upon that power that might be read into it as a result of the

[11] Fundamentally, wholly apart from the Sixteenth Amendment, the issuance or receipt of a stock dividend is as proper a subject for an unapportioned tax as an agreement to sell a share of stock (*Thomas* v. *United States*, 192 U. S. 363) or the issuance of bank notes (*Veazie Bank* v. *Fenno*, 8 Wall. 533). Nor can there be any valid objection under the due process clause or otherwise that the stock dividend is blended together with other income of the recipient for the purpose of determining the effective rate of surtax. The taxpayer's ability to pay may be taken into account in fixing the amount of the burden. Cf. *Maxwell* v. *Bugbee*, 250 U. S. 525; *Atl. & Pac. Tea Co.* v. *Grosjean*, 301 U. S. 412. The fact that the tax is described as a tax upon "income" is constitutionally irrelevant, if the legislature in fact has the power to impose it. Cf. *Wisconsin* v. *J. C. Penney Co.*, 311 U. S. 435, 443.

Pollock case.[12] Taking Article I and the Sixteenth Amendment together, we submit that there is the most ample authority for an unapportioned tax upon stock dividends.

B. *Stock dividends based upon corporate earnings or profits are taxable to the stockholders under Article I and the Sixteenth Amendment without apportionment*

1. It was recognized by this Court some twenty years before the *Pollock* decision that stock dividends were properly taxable under the Civil War income tax laws. *Bailey v. Railroad Co.*, 22 Wall. 604, 635. Indeed, the pivotal question in the *Bailey* case was whether the distribution of certain "certificates" was the equivalent of a stock dividend, it being conceded that if it were, the distribution would be taxable. Stock dividends were thus historically treated *as income*, and whatever adverse effect the *Pollock* case might otherwise have had upon the taxability of stock dividends without apportionment, must be regarded as having been removed by the Sixteenth Amendment.

It should be recalled that the Sixteenth Amendment was in effect a reversal of the *Pollock* decision, and, like every other constitutional provision, it should be broadly interpreted so

[12] Cf. *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103, 112; *Peck & Co.* v. *Lowe*, 247 U. S. 165.

as to give Congress whatever power can reasonably be read into its terms. Cf. *McCulloch* v. *Maryland*, 4 Wheat. 316, 407; *Martin* v. *Hunter's Lessee*, 1 Wheat. 304, 326. The approach of the Supreme Judicial Court of Massachusetts with respect to a similar amendment to the state constitution is peculiarly relevant here. An amendment had been adopted authorizing the state to tax "income," and the charge was made that a stock dividend could not be taxed under that amendment. In rejecting that contention the court pointedly declared (*Tax Commissioner* v. *Putnam*, 227 Mass. 522, 525–526):

> The adoption and ratification of the Forty-fourth Amendment under these circumstances renders imperative the inference that the word "income" was there used with the purpose of setting at rest any doubt about the full and complete power of the Legislature to deal with "income" as a subject of taxation. That word was employed to express a comprehensive idea. If is not to be given a narrow or constricted meaning. It must be interpreted as including every item which by any reasonable understanding can fairly be regarded as income. * * *

And even after this Court's decision in *Eisner* v. *Macomber*, the Massachusetts court adhered to its prior decision. *Lanning* v. *Tax Commissioner*, 247 Mass. 496. See also *People ex rel. Pullman Co.* v. *Glynn*, 130 App. Div. 332, affirmed, 198 N. Y.

605. The Supreme Court of Wisconsin likewise followed the approach of the Massachusetts court, in preference to the result in *Eisner* v. *Macomber*, saying (*State ex rel. Dulaney* v. *Nygaard*, 174 Wis. 597, 607–608):

> It seems to us incredible that they [the legislature and the people] expected that the gains of stockholders in corporations should be increased indefinitely and that the liability of those gains to taxation should depend upon the manner in which boards of directors should declare the profits. It seems far more consistent with the general purpose of the amendment that they were considering substance rather than form and that they did not intend that the advantages and gains of stockholders derived from their investments should remain free from taxation, while other citizens, perhaps less able to pay, should bear the burden.

The foregoing considerations point inevitably to the conclusion that whatever philosophic or technical arguments may be advanced to show that stock dividends are not income for some purposes,[11] it has long been widely and popularly understood that such dividends, when based upon corporate earnings, may constitute income. And it is in the

[11] Cf. *Gibbons* v. *Mahon*, 136 U. S. 549, and the discussion with respect to the issues raised by that case in the dissent of Mr. Justice Brandeis in *Eisner* v. *Macomber*, 252 U. S. at 234–236.

light of these considerations that the Sixteenth Amendment should be read. As was stated by Mr. Justice Holmes in his dissent in *Eisner* v. *Macomber*, 252 U. S. at 220:

> The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. * * *

2. The tax may be sustained upon grounds that are even more fundamental. For, as we shall endeavor to show, Congress has the authority to tax the stockholder on his pro rata share of his corporation's earnings, whether or not they have actually been distributed. In the last analysis, a corporation is an association of persons formed for the purpose of conducting an enterprise,[14] and there is no reason under the Constitution why Congress may not require those who are beneficially interested in the enterprise to account for its earnings regardless of whether they have in fact been segregated for distribution. The stockholder's pro rata share of those earnings may constitutionally be treated as "income" to him, and, *a fortiori*, it may constitute income to him in the constitutional sense when embodied in a stock dividend.

---

[14] See *Marshall* v. *Baltimore and Ohio Railroad Co.*, 16 How. 314, 327; Morawetz, Private Corporations (Second Edition, 1886), Volume 1, preface; Hohfeld, Nature of Stockholders' Individual Liability for Corporation Debts, 9 Col. L. Rev. 285 (1909).

A strong analogy is furnished in the case of partnerships. The revenue acts have consistently provided that partners shall be taxed upon their distributive share of the partnership profits, whether or not the profits are in fact distributed, and whether or not the partnership has a separate juristic personality under applicable state law. Nor is it any answer to say that a partner may always call for his share of the profits as opposed to a stockholder who must await the action of the appropriate corporate officers. For, this Court has already held that a partner is chargeable with his allocable share of the partnership earnings, even though they could not in fact be distributed to him under applicable state law. *Heiner* v. *Mellon*, 304 U. S. 271. Mr. Justice Brandeis thus summarized the issue (304 U. S. at 280–281):

> The Mellons contend that under the law of Pennsylvania no distribution of profits could lawfully have been made by the surviving partners as liquidating trustees until all debts and liabilities, contingent or otherwise, had been paid or satisfied, and the partners' capital returned; and that although the business of the partnerships had been carried on after dissolution precisely as before, and the partnership accounts for the year 1920 showed large profits earned, their respective shares of them were not distributable and could not be deemed taxable income of the partners.

Section 218 (a) of the Revenue Act of 1918 provides that "There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year . . . ." If "distributive" meant "currently distributable under state law," the contentions made by the Mellons might have some force. But it does not. Article 322 of Regulations 45 (and corresponding articles of subsequent Regulations) defines "distributive" as meaning "proportionate." Compare *Earle* v. *Commissioner*, 38 F. (2d) 965, 967–68 (C. C. A. 1). And § 220 of the Revenue Act of 1918, taxing to the shareholders the income of a corporation improperly accumulating its gains and profits for the purpose of avoiding surtax, assumes that the two words are synonymous. *The tax is thus imposed upon the partner's proportionate share of the net income of the partnership, and the fact that it may not be currently distributable, whether by agreement of the parties or by operation of law, is not material.* * * * [Italics supplied.]

In states where a partnership is treated as a separate entity there is little difference between such a business association and a corporation. The analogy may be made more complete by considering such a partnership with one or more limited partners. In substance the limited partner would be in very much the same position with

respect to the profits of the business as a shareholder in a corporation. Unless the other partners agree to a distribution of the profits, his distributive share is hardly more accessible to him than a shareholder's equitable interest in his corporation's earnings. Yet it is not open to serious dispute that the partner is taxable upon his allocable share of the profits; and there should be no greater obstacle under the Constitution to a similar tax upon stockholders.

Moreover, a tax upon stockholders with respect to corporate earnings is not without precedent. Several of the Civil War income tax acts specifically taxed corporate earnings directly to the stockholders, whether distributed or not. Although the tax was challenged, it was sustained by this Court in *Collector* v. *Hubbard*, 12 Wall. 1, 18:

> But the decisive answer to the proposition is that Congress possesses the power to lay and collect taxes, duties, imposts, and excises, and it is as competent for Congress to tax annual gains and profits before they are divided among the holders of the stock as afterwards, and it is clear that Congress did direct that all such gains and profits, whether *divided or otherwise*, should be included in estimating the annual gains, profits, or income liable to taxation under the provisions of that act.

To be sure, the majority opinion in *Eisner* v. *Macomber* stated that the *Hubbard* case had been overruled by the *Pollock* case; yet it seems quite

clear that even if that were true, the Sixteenth Amendment in turn deprived the *Pollock* case of that consequence. Moreover, the *Hubbard* case had been cited with approval in at least several cases after the *Pollock* decision. See *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330, 336; *Lynch* v. *Turrish*, 247 U. S. 221, 228. See also *Lynch* v. *Hornby*, 247 U. S. 339, 343. But still more significantly, the Court has in recent years again indicated that Congress might frame a tax law which would tax corporate income directly to the shareholders. *Helvering* v. *Nat. Grocery Co.*, 304 U. S. 282, 288. Cf. *McCreery* v. *McColgan*, 17 Cal. (2d) 555. And in a variety of instances, both Congress [15] and this Court [16] have taken into account

[15] The provisions relieving intercorporate dividends in large part from tax recognize the essential character of a corporation. See Internal Revenue Code, Section 26 (b). Compare the provisions relieving dividends received by individuals from normal tax. Section 216 (a) of the Revenue Acts of 1921, 1924, and 1926; Section 25 (a) (1) of the Revenue Acts of 1928, 1932, and 1934. And the provisions relating to consolidated returns for affiliated corporations likewise disregarded the corporate fiction to a rather considerable extent. See Section 240 of the Revenue Acts of 1918, 1921, 1924, and 1926; Section 141 of the Revenue Acts of 1928, 1932, 1934, 1936, 1938, and the Internal Revenue Code.

[16] *Higgins* v. *Smith*, 308 U. S. 473; *Griffiths* v. *Commissioner*, 308 U. S. 355; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330; *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71. Cf. *United States* v. *Lehigh Valley R. R. Co.*, 220 U. S. 257, 272–274; *Chicago, M. & St. P. Ry. Co.* v. *Minn. Civic Assn.*, 247 U. S. 490, 500–501; *United States* v. *Reading Co.*, 253 U. S. 26; *Northern Securities Co.* v. *United States*, 193 U. S. 197; *Standard Oil Co.* v. *United States*, 221 U. S. 1, 75; *United States* v. *U. S. Steel Corp.*, 251 U. S. 417.

the essential nature of a corporation as the alter ego of its shareholders in determining tax liability.

The facts of the instant case furnish a striking example for the consideration of this question. The petitioner is the sole stockholder and has been conducting a profitable business through his corporation. In truth and in substance, as the corporation has been earning money the petitioner has been earning that money, and we submit that there is nothing in the Constitution that forbids Congress to treat those earnings as belonging to the petitioner without awaiting any formal distribution to him. And if Congress has the power to require a stockholder to account annually for his pro rata share of the corporate earnings, surely it has the lesser power of charging him with the earnings at such convenient times as they may be segregated and made the basis for a stock dividend. Viewed in terms of constitutional power the taxation of corporate profits to the shareholders at the time of a stock dividend merely amounts to a postponement of the reckoning between the shareholder and the Government—a reckoning which Congress could have required at an earlier time.

3. We have contended above that the decision in *Eisner* v. *Macomber* not only misconceived the broad scope of the taxing power under Article I but that it failed to recognize the known purpose of the Sixteenth Amendment. In addition, the decision has introduced various concepts and re-

finements as to the "realization" of "income" which are demonstrably erroneous in the light of subsequent decisions of this Court.

(a) The majority opinion in *Eisner* v. *Macomber* stated the rationale of the decision as follows (252 U. S. at 211):

> The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. * * *

But later decisions of this Court have utterly destroyed the theory that there can be no income to the shareholder unless there is an "outgo" from the corporation. Thus, *Koshland* v. *Helvering*, 298 U. S. 441, ruled that a distribution of common stock to preferred stockholders resulted in income to the distributees notwithstanding that the corporation did not in any way part with any of its assets. A like result was reached in *Helvering* v. *Gowran*, 302 U. S. 238, where preferred stock was issued to the common stockholders. Cf. *Doerschuck* v. *United States*, 274 Fed. 739 (E. D. N. Y.) (distribution of bonds); *United States* v. *Fuller*, 42 F.

(2d) 471 (E. D. Pa.) (same). In neither the *Koshland* nor the *Gowran* case did the stockholder receive anything "out of the company's assets." And in both cases the original investment together with accretions and accumulations remained the "property of the company, and subject to business risks which may result in wiping out the entire investment." The critical consideration, however, is that the corporation in each case had earnings against which the stock dividend could be allocated, and it was appropriate at that time to charge the stockholder with his share of those corporate earnings.

Indeed the foregoing test laid down in *Eisner* v. *Macomber* was repudiated even before the *Koshland* and *Gowran* cases. *United States* v. *Phellis*, 257 U. S. 156; *Rockefeller* v. *United States*, 257 U. S. 176; *Cullinan* v. *Walker*, 262 U. S. 134; *Marr* v. *United States*, 268 U. S. 536; but cf. *Weiss* v. *Stearn*, 265 U. S. 242.

In the *Phellis* case, each shareholder of a New Jersey corporation received two shares of stock in a newly formed Delaware corporation for each share held in the New Jersey corporation, without surrendering the original stock. All of the assets of the New Jersey corporation were transferred to the Delaware corporation. The Court of Claims, following *Eisner* v. *Macomber*, held that the receipt of the new stock did not constitute income. This Court reversed, notwithstanding that the new

corporation was formed to continue the same business that had been carried on by the old corporation; that there was no change in the corporate objects and purposes or in the personnel of the officers or stockholders; and that there was no change in the proportionate interest of any stockholder, the aggregate of the new and old shares representing interests of the same extent in the same enterprise. The *Rockefeller* case presented substantially similar facts, except that the new corporation was formed in the same state as that of the old, and only part of the business was transferred to it.

In *Cullinan* v. *Walker,* a Texas corporation dissolved and the trustees organized two new Texas corporations to which the assets were distributed in exchange for all of the stock and bonds of the new companies. These securities were then exchanged for stock of a newly formed Delaware holding corporation, which stock, together with the bonds of the two new Texas corporations, was distributed to the shareholders of the original Texas corporation. Those shareholders were held to have realized income upon the acquisition of the new stock.

In *Marr* v. *United States,* a shareholder who held both common and preferred stock in a New Jersey corporation received from a newly formed Delaware corporation, to which all of the assets of the old corporation had been transferred, five

shares of common stock in exchange for each share of New Jersey common, and one and one-third preferred shares in exchange for each share of New Jersey preferred. The exchange was held to have constituted a realization of income.

In none of these cases was there any distribution of the assets of the corporation to its shareholders. There was no "outgo." The assets, or part of them, were merely transferred from one company to another identical in composition and business purpose, and the shareholders' formal evidences of their interests in the business, which interests had undergone no substantive change, were corrected correspondingly.

Formal distinctions of the character manifested by *Eisner* v. *Macomber*, on the one hand, and the *Phellis*, *Rockefeller*, *Cullinan*, *Marr*, *Koshland*, and *Gowran* cases, on the other hand, have, we submit, no basis in the broad language of the Sixteenth Amendment, which was intended "to get rid of nice questions as to what might be direct taxes" (Holmes, J., p. 220, dissenting in *Eisner* v. *Macomber*). The subtle refinements between different kinds of stock dividends might support differences in legislative treatment, but such distinctions do not afford grounds for a restrictive construction of a constitutional provision, especially one whose generating motives are like those which gave rise to the Sixteenth Amendment.

(b) The majority opinion in *Eisner* v. *Macomber* also laid down the erroneous requirement that

even though there be actual gain it cannot be treated as "income" under the Sixteenth Amendment unless it is "severed from" capital and available to the recipient for his "separate" use. Thus, it was stated (252 U. S. at 207):

> Here we have the essential matter: *not* a gain *accruing to* capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital however invested or employed, and *coming in*, being *"derived,"* that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description. [Italics in original.]

We submit that such restriction upon the broad language[11] of a constitutional provision was

[11] The majority opinion fastened upon the word "derived" in the Sixteenth Amendment as indicating that the gain or profit must be "severed" before it can be treated as income (252 U. S. at 207–208). But that approach involved a distortion of the amendment as a whole, and ignored its well-known purpose. It will be recalled that the Amendment was adopted in response to the *Pollock* case which had held that certain income could not be taxed without apportionment by reason of its source. The Sixteenth Amendment undertook to do away with that result, and provided that income could be taxed without apportionment "from whatever source derived." These were sweeping words, indicating that the apportionment requirement was not to apply to any kind of income whatever. It seems ironic that these words, which were intended to expand the power of Congress, were converted by the majority into words of limitation.

wholly unwarranted, as has since been shown by numerous decisions of this Court. Thus, it has often been held that taxable income may be involved when neither money nor property has been received. The accrual of such benefits as the discharge of the taxpayer's indebtedness,[18] or the payment of his taxes by another,[19] or the satisfaction of other obligations[20] or even the discharge of a mere "social duty",[21] has consistently been treated as taxable income.

Similarly, in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1, it was held that the "book" profit resulting from a corporation's purchase and retirement of its own bonds for less than the amount at which they were issued constitutes income. And the doctrine of the *Kirby* case has even been extended to a situation where the taxpayer's obligations had originally been issued for property rather than money. *Helvering* v. *American Chicle Co.*, 291 U. S. 426. In that case, the discharge of the obligations at less than par was held to consti-

[18] *United States* v. *Hendler*, 303 U. S. 564; *Duffin* v. *Lucas*, 55 F. (2d) 786 (C. C. A. 6th), certiorari denied, 287 U. S. 611.

[19] *Old Colony Tr. Co.* v. *Commissioner*, 279 U. S. 716.

[20] *Douglas* v. *Willcuts*, 296 U. S. 1; *Helvering* v. *Schweitzer*, 296 U. S. 551; *Helvering* v. *Blumenthal*, 296 U. S. 552; *Helvering* v. *Fitch*, 309 U. S. 149; *Helvering* v. *Leonard*, 310 U. S. 80.

[21] *Burnet* v. *Wells*, 289 U. S. 670. See also *Helvering* v. *Clifford*, 309 U. S. 331; *Helvering* v. *Horst*, 311 U. S. 112; *Helvering* v. *Eubank*, 311 U. S. 122; *Lucas* v. *Earl*, 281 U. S. 111.

tute income in the amount of the difference, not a mere reduction in the purchase price of the property, as held by the lower court.[22] Indeed, even the *purchase* of property at a price less than its fair market value may, in some circumstances, be treated as an income producing transaction, or more accurately, as a point at which it is appropriate to measure the taxpayer's increase in wealth.[23]

Whatever residual doubt there may have been as to the unsoundness of the "severability" requirement set forth in *Eisner* v. *Macomber* has been finally put at rest by *Helvering* v. *Bruun*, 309 U. S. 461. There, a tenant had erected a new building upon leased land and had thereafter defaulted upon the lease. The lessor, who thus recovered not only the land but also the building attached to it, contended that even though the building represented a gain to him it could not be treated as "income" because it was inseparable from his capital (the land) and could be taxed

[22] *Commissioner* v. *American Chicle Co.*, 65 F. (2d) 454 (C. C. A. 2d).

[23] *Robinson* v. *Commissioner*, 59 F. (2d) 1008 (C. C. A. 6th); *Salvage* v. *Commissioner*, 76 F. (2d) 112 (C. C. A. 2d), affirmed, 297 U. S. 106; *Hawke* v. *Commissioner*, 109 F. (2d) 946 (C. C. A. 9th); *Helvering* v. *Commercial Investment Trust Corp.*, 74 F. (2d) 1015 (C. C. A. 2d), affirming, *per curiam*, 28 B. T. A. 143; *Haberman* v. *Commissioner*, 31 B. T. A. 75, affirmed, *per curiam*, 79 F. (2d) 995 (C. C. A. 2d); *Alger-Sullivan Lumber Co.* v. *Commissioner*, 57 F. (2d) 3 (C. C. A. 5th); *Indianapolis Glove Co.* v. *United States*, 96 F. (2d) 816 (C. C. A. 7th); *Bothwell* v. *Commisioner*, 77 F. (2d) 35 (C. C. A. 10th).

only at such time as he might sell it. This Court paid but scant attention to *Eisner* v. *Macomber*, and definitely rejected the concept of "severability" as a limitation upon the meaning of income under the Sixteenth Amendment (p. 469):[24]

> It is not necessary to recognition of taxable gain that he [the taxpayer] should be able to sever the improvement begetting the gain from his original capital. If that were necessary, no income could arise from the exchange of property; whereas such gain has always been recognized as realized taxable gain.

We respectfully submit that the question of "realization" of income is not one which can be appropriately dealt with by a restrictive judicial definition. Fundamentally, the problem is simply one of finding an appropriate time for the measurement of an increase in wealth. That problem is essentially, and by its very nature, legislative in character, and we urge that under the Sixteenth Amendment, which was intended to make possible an equitable system of progressive income taxation, resolution of such questions was placed in the legislative branch of the Government. Congress should be left free to designate any convenient event as appropriate for the measurement of increases in wealth. The concept of

[24] Indeed, so far as ease of disposition is concerned, the recipient of a stock dividend probably could sell it with greater ease than could the lessor in the *Brown* case sell the building without the land.

"realization" should impose no greater restraint than this. The declaration of a stock dividend based upon corporate earnings is certainly an event at which it is appropriate to measure the increase in wealth which has accrued to a stockholder by virtue of the successful operation of the business in which he is beneficially interested.

(c) Another fundamental misconception which appeared to pervade the entire decision in *Eisner* v. *Macomber* was that there could be no income through the distribution of a stock dividend because the stockholder's position after the dividend was the same as before. Of course, we do not contend that the mere declaration of a stock dividend is a wealth producing transaction. The same is true in the case of a cash dividend; for the stockholder is generally no wealthier immediately after the distribution than before, since the payment of the dividend out of the corporate assets reduces *pro tanto* his financial interest in the corporation. The essential fact is that in the normal situation the corporate earnings have been accumulating over a period of time and have gradually enriched the stockholder in proportion to his holdings. And the distribution of the dividend, whether in cash or in stock merely marks a convenient point at which that increase in wealth may be charged against those who are equitably entitled thereto.[25]

[25] Of course, it may be that the stockholder had acquired his stock after the corporation had realized the earnings in question. But the same situation would exist even in the

The profit derived from the increase in value of a capital asset is analogous. Suppose, for example, that a taxpayer has an asset for which he had paid $10,000 but which has risen in value over a period of time so that it becomes worth $20,000. If the taxpayer should sell that asset for $20,000 or should exchange it for some other property of the same value, it is clear that he would be no wealthier immediately after the sale or exchange than immediately before. Yet the sale or exchange marks the time that Congress has selected to require him to account for a gain that had been accruing up to that time. He is taxed, not on the $20,000 which he receives, but only upon the amount of gain reflected therein. Similarly, in the case of corporate dividends, whether in cash or stock, the tax is levied only to the extent that the dividends are

---

case of a cash dividend, and it is undisputed that the distribution of a cash dividend out of the corporation's earnings is taxable regardless of when the recipient became a stockholder. Cf. *Lynch* v. *Hornby*, 247 U. S. 339; *Peabody* v. *Eisner*, 247 U. S. 347; *United States* v. *Phellis*, 257 U. S. 156. Since Congress has provided for the postponement of taxing the corporate earnings to the stockholders until there has been a dividend, it is necessary in order to preserve continuity, that each new stockholder be treated as stepping into the shoes of his predecessor. The principle is one that has long been familiar in our revenue laws, and has been approved by this Court in the analogous situation where the owner of property is in some circumstances required to take over the basis of his predecessor for the purpose of computing gain or loss upon sale. *Taft* v. *Bowers*, 278 U. S. 470; *Cooper* v. *United States*, 280 U. S. 409.

based upon earnings. Naturally, there would be no income to a stockholder if the corporation had no earnings and there were a 10 for 1 split-up of its shares. We make no such fantastic contention. We say merely that the declaration of a stock dividend marks the time which Congress may select as the occasion to reckon the gain that has been accruing to stockholders through the earnings of their corporation.[26]

[26] Although we contend that a stock dividend based upon corporate earnings may be treated as income under the Sixteenth Amendment even if it results in no essential change in the stockholder's position, it is obvious that it may effect a material change in his rights. The holder of a $100 share in a corporation has the right to have that sum retained in the business as capital. If a 100 percent stock dividend is paid, he now has the right to have $200 retained in the business as capital. The prior surplus can no longer be used for dividends, nor can it be used to purchase the corporation's own shares. The consent of a large proportion of the shareholders, and perhaps of the creditors or a court, is now required to reduce the capital stock and recreate the surplus. See Fletcher, Cyclopedia Corporations, Volume 11 (1932), Sections 5149, 5150. If the corporation's borrowing power is limited by the amount of its capital stock (see Fletcher, *supra*, Volume 6 (1931), Section 2615, fn. 65), the dividend has increased the borrowing power correspondingly. Concomitantly new obligations may have been created. Many state statutes impose personal liability upon shareholders for certain kinds of corporate debts and generally the liability is measured by the par or stated value of the stock held by each shareholder. See Fletcher, *supra*, Volume 13 (1932), Section 6277. A stock dividend increases this potential liability *pro tanto*.

C. *Eisner* v. *Macomber* should be expressly overruled

If, as we contend, *Eisner* v. *Macomber* was erroneously decided, then we submit that it should be expressly overruled. Although the distinctions made by the later cases have considerably narrowed the operative scope of that decision, the process of limitation has now reached the point where it has become exceedingly difficult to reconcile the basic theories of the decided cases.[27] An additional distinction will but serve further to obfuscate the basic issue, and to accentuate the need for the inevitable remedy which only this Court can provide in such a situation.

Of even greater moment is the hampering influence which the decision has cast upon the legislative development of an effective method of taxing corporate earnings. It has been a chronic and most difficult problem to achieve equality of the ultimate thrust of the tax burden upon persons in the same income levels. For example, it was estimated that the insulation between corporate earnings and indi-

[27] Illustrative of the confusion produced by *Eisner* v. *Macomber* is the fact that Congress thereafter specifically exempted all stock dividends from tax, thinking that such a sweeping exemption was constitutionally required by the decision. See *Koshland* v. *Helvering*, 298 U. S. 441, 444–445, and discussion, *supra*, pp. 10–11. It was not until after the *Koshland* decision, some fifteen years later that Congress in Section 115 (f) of the Revenue Act of 1936 substituted a provision making taxability of such dividends coextensive with constitutional powers, thereby leaving the question to the courts.

vidual surtax would result in a loss of more than 600 million dollars in revenue in 1937. See S. Rep. No. 2156, 74th Cong., 2d Sess., part 2, p. 2. It was also pointed out that a converse effect was to place a disproportionately heavy burden upon small stockholders in low income levels. The undistributed profits tax under the Revenue Act of 1936 was an unsuccessful attempt to correct some of these inequities.

Other methods might be attempted if it were made clear that *Eisner* v. *Macomber* did not stand in the way. For example, the decision impelled Congress to abandon the taxation to the shareholders of the profits of a corporation formed or availed of for the purpose of avoiding surtax, and the similar method of taxing the profits of personal service corporations. See H. Rep. No. 350, 67th Cong., 1st Sess., pp. 12, 16; S. Rep. No. 275, 67th Cong., 1st Sess., pp. 16, 34. Compare the provisions of Section 337 of the Internal Revenue Code relating to foreign personal holding companies, where Congress has undertaken to tax corporate earnings directly to the stockholder in order to prevent avoidance. Conceivably if it were freed of the restrictive effect of *Eisner* v. *Macomber*, Congress might adopt some such method of taxing earnings of domestic corporations.[28] In any event

[28] See H. Rep. No. 1860, 75th Cong., 3d Sess., pp. 2–3 (1939–1 Cum. Bull. (Part 2) 728, 729):

> Much tax avoidance had undoubtedly occurred in years prior to 1936, by the avoidance of individual

it is of the utmost public importance that Congress be free to develop fiscal policies unhampered by the shadow of erroneous constitutional limitations. Only a complete excision of *Eisner* v. *Macomber* from the body of constitutional law can accomplish this result, for obviously no system of taxation may be adopted as a major part of the fiscal scheme so long as there exists even a doubt as to its ultimate fate in the courts.

---

surtaxes through the retention of profits by corporations when such retention was unnecessary.

The opportunity for such tax avoidance in this manner has long been recognized. It may be that this was one of the reasons why, in the Civil War Income Tax Act of 1864, the general rule was to tax corporate profits to the shareholder whether or not such profits were distributed to him. In the light of court decisions since that time, there is some support for the contention that this system of taxation is unconstitutional for domestic corporations.

Several commentators have thought that *Eisner* v. *Macomber* precluded such a system of taxation for domestic corporations; see Ballantine, Corporate Personality in Income Taxation, 34 Harv. L. Rev. 573, 581 (1921); Seligman, Implications and Effects of the Stock Dividend Decision, 21 Col. L. Rev. 313, 323 (1921); Martin, Taxation of Undistributed Corporate Profits, 35 Mich. L. Rev. 44, 45 (1936); although the contrary view has also been expressed: see Powell, The Stock Dividend Decision and the Corporate Nonentity, 5 Nat. Tax Assn. Bull. 201 (1920); Clark, *Eisner* v. *Macomber* and Some Income Tax Problems, 29 Yale L. J. 735, 742 (1920); Traynor, Tax Decisions of the Supreme Court, 1937 Term, 33 Ill. L. Rev. 371, 388 (1938).

II

THE DECISION BELOW IS CORRECT EVEN IF EISNER V. MACOMBER BE PERMITTED TO STAND

As an alternative argument we submit, as held by the court below,[a] that the decision below is correct even if *Eisner* v. *Macomber* be not overruled. This case falls within the doctrine of *Koshland* v. *Helvering*, 298 U. S. 441, and *Helvering* v. *Gowran*, 302 U. S. 238. In the *Gowran* case, as here, there was a dividend of preferred stock on common. It is true that in the *Gowran* case there was some preferred stock outstanding at the time the dividend was declared, but we do not believe that fact to be of controlling significance. On the contrary, the important fact is that the distribution of a new kind of stock gives the recipient rights which are of a different character from those which he previously owned.[b]

In the instant case, as the Board pointed out (R. 16–17), the new stock differed substantially from the old. Since the new stock carries no voting rights it might be disposed of without affecting

[a] A contrary result was reached in *Dreyfuss* v. *Manning*, 44 F. Supp. 383 (N. J.), now on appeal to C. C. A. 3d.

[b] In this connection it is to be noted that in neither the *Koshland* nor the *Gowran* opinion was emphasis placed upon the fact that more than one class of stock was outstanding at the time the dividend was declared. In each instance the fact was merely noted without comment. In *Helvering* v. *Pfeiffer*, 302 U. S. 247, a companion proceeding to the *Gowran* case, the fact was not even mentioned.

petitioner's control of the corporation. It carries with it the right to the payment of a fixed annual amount before dividends may be paid upon the common stock, and this right is cumulative. All of these new rights may be disposed of without affecting the petitioner's preexisting interest as the holder of the common stock. It cannot be said therefore that the stock dividend was a mere proliferation of an existing interest.

It is true that there was no change in the petitioner's proportionate interest in the assets of the corporation, but that should not be of importance since the test is as follows (*Koshland* v. *Helvering*, *supra*, at p. 446): "where a stock dividend gives the stockholder an interest different from that which his former stockholdings represented he receives income." See also *Helvering* v. *Gowran*, *supra*, at 240–241.

To be sure a stock dividend which worked a change in a stockholder's proportionate interest in the corporation's assets would also constitute a taxable dividend, but we submit that *either* such a change in interest *or* the receipt of different rights brings a case within the rule of the *Koshland* decision.[21] Indeed, if the test were that there *must* be a change in proportionate interest, a dividend paid in cash would not constitute income.

[21] See *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, 225: "Income may be realized upon a change in the nature of legal rights held, though the particular taxpayer has enjoyed no addition to his economic worth."

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.
SAMUEL O. CLARK, JR.,
Assistant Attorney General.
SEWALL KEY,
ARNOLD RAUM,
GERALD L. WALLACE,
BERNARD CHERTCOFF,
Special Assistants to the Attorney General.

OCTOBER 1942.

APPENDIX

Constitution of the United States:

Article I, Section 2, Clause 3.—Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three fifths of all other Persons. * * *

Article I, Section 8, Clause 1.—The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;

Article I, Section 9, Clauses 4 and 5.—No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

No Tax or Duty shall be laid on Articles exported from any State.

* * * * *

Sixteenth Amendment.—The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from * * * dividends, * * *.

* * * * *

(d) *Distributions by Corporations.*—Distributions by corporations shall be taxable to the shareholders as provided in section 115.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

* * * * *

(f) *Stock Dividends.* —

(1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

* * * * *

(j) *Valuation of Dividend.*—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

Treasury Regulations 94, relating to the Revenue Act of 1936:

ART. 115–7. [The material reproduced herein represents Article 115–7 as it was originally promulgated. However, by T. D. 5110, *infra*, only the first sentence now remains.] Stock dividends.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. The Supreme Court has pointed out some of the characteristics distinguishing a stock dividend which constitutes income from one which does not constitute income within the meaning of the Constitution.[1] The distinction between a stock dividend which does not, and one which does, constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution is

---

[1] See *Eisner* v. *Macomber* (252 U. S., 189, T. D. 3010, C. B. 3, 25); and *Koshland* v. *Helvering* (56 Sup. Ct., 767, Ct. D. 1124, C. B. XV-1, 219). Compare *United States* v. *Phellis* (257 U. S., 156, T. D. 3270, C. B. 5, 37); *Rockefeller* v. *United States* (257 U. S., 176, T. D. 3271, C. B. 5, 34); *Cullinan* v. *Walker* (262 U. S., 134, T. D. 3508, C. B. 11–2, 355); *Weiss* v. *Stearn* (265 U. S., 242, T. D. 3609, C. B. III–2, 51); and *Marr* v. *United States* (268 U. S., 536, T. D. 3755, C. B. IV–2, 116).

the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus the old representing the same proportionate interest in the net assets of the corporation as did the old.

Example (1): The X Corporation had an authorized capital stock of $300,000 of common stock, par value $10 a share, and $100,000 of 7 percent cumulative preferred stock, par value $100 a share, which is preferred as to dividends, has no voting rights, and may be redeemed at any time at $105 per share. The articles of incorporation provide that the annual dividend on the preferred stock may be paid in cash or, at the option of the corporation, in one share of common stock for each share of preferred. On July 1, 1936, the X Corporation had outstanding $200,000 of common stock and $100,000 of preferred stock, earnings and profits of $60,000 accumulated since February 28, 1913, and earnings and profits of the taxable year amounting to $15,000. On July 1, 1936, it distributed

1,000 shares of its common stock of an aggregate par value (and fair market value) of $10,000 to the holders of its preferred stock in payment of the annual dividend on such stock. The stock so distributed constitutes a taxable stock dividend to the holders of the preferred stock.

Example (*2*): On July 1, 1936, the Y Corporation had an authorized capital stock consisting of 1,000 shares of common stock, par value $100 a share, of which 500 shares were outstanding. It had earnings and profits of $40,000 accumulated since February 28, 1913, and $5,000 of earnings and profits of the taxable year. On July 1, 1936, the Y Corporation issued and divided among its shareholders 250 additional shares of its common stock of a total par value of $25,000 and transferred an equivalent amount from surplus account to capital stock account. The stock so distributed does not constitute a taxable stock dividend to the shareholders.

Example (*3*): The Z Corporation had an authorized capital stock of 30,000 shares of common, without par value, and 10,000 shares of 7 percent-cumulative preferred stock, par $100, which is preferred as to dividends, has voting rights and may be redeemed on the 1st of January or July of any year by the payment of $105 per share and accrued dividends. On July 1, 1936, the company's issued and outstanding stock amounted to 20,000 shares of common and 6,000 shares of preferred, and it had $250,000 earnings and profits accumulated since February 28, 1913, and $90,000 earnings and profits of the taxable year. On July 1, 1936, it paid a dividend on its common stock in preferred stock at the rate of 1/10 share

of preferred on each share of common outstanding. The preferred stock so distributed constitutes a taxable stock dividend to the holders of common stock.

T. D. 5020, 1940–2 Cum. Bull. 118:

Section 19.115–7 of Regulations 103 [Part 19, Title 26, Code of Federal Regulations, 1940 Sup.] is amended by striking out all of the matter appearing after the first sentence thereof.

T. D. 5110, 1942–4 Int. Rev. Bull. 7:

Article 115–7 of Regulations 94 [section 3.115–7, Title 26, Code of Federal Regulations] and article 115–7 of Regulations 101 [section 9.115–7, Title 26, Code of Federal Regulations, 1939 Sup.] are each amended by striking out all of the matter appearing after the first sentence thereof.

U. S. GOVERNMENT PRINTING OFFICE: 1943